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Why Five? The Strange, Magnetic, and Mesmerizing Affect of the Five Percent Unitrust and Spending Rate on Settlors, Their Advisors, and Retirees

Joel Dobris

WHY FIVE? THE STRANGE, MAGNETIC, AND MESMERIZING AFFECT OF THE FIVE PERCENT UNITRUST AND SPENDING RATE ON SETTLORS, THEIR ADVISERS, AND RETIREES

Joel C. Dobris*

Editors' Synopsis: Investment literature aimed at trustees and retirees often assumes that investors can obtain a return sufficient to support a five percent annual payout without impairing capital. According to the author, truly sophisticated commentators see this as over-optimistic. This disconnect between investor fantasy and investment reality is the topic of this Article. The author explores the idea primarily in a trust context.

"I often say that when you can measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meagre and unsatisfactory kind: it may be the beginning of knowledge, but you have scarcely, in your thoughts, advanced to the stage of *science*, whatever the matter may be."**

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* Professor of Law, School of Law, University of California, Davis ("UCD"). I thank: Rex R. Perschbacher, Kevin Johnson, Gordon Anthon, Jack Ayer, Holly D. Doremus, Katy Filner, Jim Garland, Taiyo Inoue, David Levine, Paul Jacobs, Robert H. Sitkoff, Lauren Willis, Bruce Wolk, Chante Gordon (UCD Class of 2006), Eric May (UCD Class of 2006), Jeff Pietsch (UCD Class of 2006), Darcy Pruitt (UCD Class of 2004), James Thompson (UCD Class of 2005), Esther Wright (UCD Class of 2004), and an anonymous editor of this Journal. I especially thank Jim Garland for encouraging me over the years and sharing his ideas with me, and I thank Esther Wright for forcing me to write this Article and for contributing importantly to it. Anything you like in this Article, they did. Anything you dislike, I did.

** Sir William Thomson Kelvin, *Electrical Units of Measurement* (May 3, 1883), in 1 POPULAR LECTURES AND ADDRESSES 73, 73-74 (London & New York, Macmillan 1889).

Assets support people and missions in a variety of contexts. Of interest here are trusts, retirement nest eggs, and endowments. The problem is that people do not understand capital's capacity to support. They do not understand what money can and cannot do for them. People are too optimistic about the productivity or "fecundity"[1] of capital. They frame the

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[1] James P. Garland, *Long-Duration Trusts and Endowments*, J. PORTFOLIO MGMT.

issue incorrectly. In trying to understand capital's support capacity, many people think in percentage terms: "I expect to earn 5% total return on my money." I think traditional trust income is a better measure of capital's support capacity, and if people must think in percentages, 5% is too high (in early 2005).

I believe this over-optimism and preference for approaching productivity in percentage terms leads too many people to be sure they can get a 5% total return. I believe this will lead to people diminishing their principal to the point that a remainder interest in trust will be devalued or even destroyed. Similarly, I despair of the inheritances of retirees' heirs, and in some circumstances, I can see retirees running out of money.

I find it all boils down to this: too many settlors of prototypical trusts concluding they can create trusts that give *A*, the income beneficiary, a 5% return and give *B*, the remainder beneficiary, unimpaired, and even enhanced, principal.[2] It ain't so.

This is an essay.[3] It is not an empirical study or a theory. It asks and

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Spring 2005, at 44.

[2] Obviously, this is a simplification. Some trustees can make 5% (e.g., Yale's endowment and large trusts for well-advised rich people). *See* Tom Sullivan, *Ivy Endowments Increase Over 16 Percent: University Yet to Release Numbers, But Five Peers Report High Returns*, YALE DAILY NEWS, Sept. 17, 2004, *available at* http://www.yaledailynews.com/article.asp?Aid=26251 (last visited Feb. 23, 2005). Other trusts properly may diminish principal (e.g., old impoverished widows with small trusts). Purpose and context are vital to understanding. Putting it another way, at one extreme some people view their capital as an endowment—the endowment is not to be violated. At the other extreme, some people want to fully cannibalize their principal—they want to die with one nickel left. Most of us are in the middle; there's not enough money to live on income alone, but we want to have some principal to pass on to the next generation. We are the quasi-cannibals. We will eat arms, but we will not eat legs.

[3] As an essay, and a piece of professional literature, many statements in this Article are based on observation, experience, intuition, and situation. The finding of empirical proof, or disproof, must be the task of others. I began another essay of mine, written a few years ago, with the same sentence and the same footnote. I have paid my taxes for fifty years and I am damn well going to write what I please. *See* Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends—An Essay*, 35 REAL PROP. PROB. & TR. J. 601, 603, n.1 (2000) [hereinafter Dobris, *The Death of the Rule Against Perpetuities*]. I make the point elsewhere by quoting Lawrence Friedman. *See* Lawrence M. Friedman, *Name Robbers: Privacy, Blackmail, and Assorted Matters in Legal History*, 30 HOFSTRA L. REV. 1093, 1094 (2002):

> Much of what follows in this Article is speculative and qualitative. But this is an exploration of legal culture, and indeed, an exploration of past legal culture; the kind of legal archaeology this Article represents almost always suffers from a lack of rigor. Some aspects of this Article might be (and should be) tested

answers a couple of interesting questions.

In the late 1980s and into the 1990s law reformers became disenchanted with the regime that if a private trust said "income to *A* for life, remainder to *B*," then *A* got the receipts traditionally understood to be income (e.g., dividends) currently and *B* got the receipts traditionally understood to be principal (e.g., capital gains) at the termination of the trust. Folks were disenchanted because trusts were not producing enough money as income while assets seemed to be increasing in value.

For many, the solution to disenchantment was the unitrust. A unitrust abolishes the distinction between income and principal and looks instead to total return from a portfolio.[4] The unitrust trustee pays out not traditional income, which is determined formalistically, but a fixed percentage of the portfolio, which is measured periodically.[5] In other words, some folks concluded that a buck is a buck, and whether the money was labeled income or principal did not matter.

If *A* gets a 5% unitrust interest, *A*'s trustee might accumulate receipts all year and look at what was on hand on December 31st and give *A* 5% of the amount on hand on January 2nd. So, if settlor put $100,000 in trust and if the $100,000 grew to $103,000 by year's end, then *A* would get $5,150 on January 2nd and the trustee would start the new year with $97,850. If the trust was a traditional trust and the $3,000 was all traditional income, *A* would get $3,000 and the trustee would start the new year with $100,000, and if the $3,000 consisted of $2,000 traditional income and $1,000 capital gain, *A* would get only $2,000 and the trustee would start the year with $101,000.[6]

If a settlor chooses a unitrust, the settlor makes two decisions: (1) to provide for the payout of some percentage of the total assets in the hands of the trustee to the income beneficiary instead of traditional income, and (2) what the percentage should be. Thus, any given unitrust impounds two

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empirically; but for other aspects, the data are simply not at hand.

As quoted in Joel C. Dobris, *Speculations on the Idea of "Speculation" in Trust Investing: An Essay*, 39 REAL PROP. PROB. & TR. J. 439, 439 n.* (2004) [hereinafter Dobris, *Speculations on the Idea of "Speculation" in Trust Investing*].

[4] *See* James P. Garland, *The Problems With Unitrusts*, 1 J. PRIVATE PORTFOLIO MGMT. 35 (1999).

[5] The annuity trust rarely is used outside the charitable remainder trust arena. A unitrust directs the trustee to pay a fixed amount to *A* each year out of trust assets without regard to the size of the trust or the nature of the receipts.

[6] In real life, the payments might be quarterly and the percentage might be a rolling three year average of values.

ideas: (1) dump the traditional income as a payout, or spending, rule, and (2) give the unitrust beneficiary a set percentage of the assets on hand (the spending rate, if you will).

A surprising number of advisers and settlors seem to be drawn to unitrusts, and a surprising number seem to be drawn to 5% unitrusts.[7] I say surprising because I do not think unitrusts are that useful,[8] and I do not think that a 5% unitrust can operate for an extended period of time without dramatically depleting principal (in early 2005).[9]

In other words, I think unitrusts are not very good,[10] and that 5% is bad.[11] One of my big problems is this: in the old days, we were ready to say "income to *A* remainder to *B"* was a one-size-fits-all for those who did not want to have invasions of principal. A market still exists for the one-size-fits-all trust as it always existed. Now that some of us are in love with unitrusts, we still want the same one-size-fits-all arrangement in unitrust form (just like the one-size-fits-all "Income to *A* for life" trust). The problem is that our greater sophistication and the inevitable effect of most unitrusts on principal means people cannot assume blithely that there is a one-size-fits-all unitrust. Picking the percentage is serious business, more serious than saying "Income to *A* for life." Why? Because unitrusts have

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[7] Professor Robert H. Sitkoff may have derived a proof that the number of unitrusts is on the rise. He hopes to write an article about this some day.

[8] *See* Garland, *supra* note 4.

[9] *See* Garland, *supra* note 1.

[10] *See* Garland, *supra* note 4. I do not like unitrusts for several reasons, including the extent to which shares are sold, the dividends and the potential for growth of the sold shares are forever gone; the stream of spendable funds is volatile, even if a smoothing rule is in place; and a great deal of the success of a unitrust, or a retirement spending plan, will depend on when the payments are begun and what is the state of the market. I prefer a trust that gives income to *A* and gives the trustee the power to invade principal for the benefit of *A* to the extent and in the fashion determined by the settlor. This allows investment for total return and does not tie the trustee to an annual payout that may not be sustainable in a particular year.

[11] *See* Garland, *supra* note 1. Simply put, people do not think clearly about investing or capital. They do not demand dividends. They expect more of stocks than dividends and earnings can provide. They accept fantasy over reality. They tolerate excess agency costs. *See* Eugene N. White, *Foxes in the Coop: Conflicts of Interests in Mutual Funds*, MILKEN INST. REV., Third Quarter 2004, at 44. They dream of lump sums when they should be thinking of income streams. Maybe courts will misunderstand their duty when they judge a fiduciary's account at the end of the trust by looking at the size of the lump sum being handed over instead of the income producing capacity of the portfolio. There is a behavioral or cognitive disconnect.

the capacity to exhaust principal and the old income-only trusts did not.[12]

The same problem affects people who have saved a nest egg for retirement or who have inherited capital. They need to decide what they will spend each year to sustain them or to supplement other income. Historically, sensible, seriously rich people living on capital (rentiers)[13] sought to live on their income,[14] spend their dividends,[15] or clip their coupons,[16] in order not to impair capital.[17] Retirees who have amassed a large enough nest egg can have a goal of preserving their capital and living either on a fixed percentage of their assets or on their income. Folks with less money know, or should know, they will need to cannibalize their capital—their nest eggs—in retirement.[18]

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[12] An interesting question, outside the scope of this Article is: What investment portfolio should the trustee of a likely long-term, high percentage unitrust use to extend the life of the trust as long as possible and to try to preserve some principal for the remainder beneficiary? Ultimately, this requires the elusive talents of market timing and asset selection. If the market is going to tank, how about 100% short-term bonds? If the market is going to soar, how about 100% equities? If the market is going to stand still, how about superb selection of specific assets such as the stock of the year?

[13] A "rentier" is "one who lives off income from capital." Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 974 n.36 (1992). Of course, rentiers are not all rich; it just seems that way sometimes.

[14] "Grandpa Chase had died and left me and Bella each a legacy that threw off an annual income of twenty-five thousand dollars. Mother, of course, got the residue." LOUIS AUCHINCLOSS, *The Epicurean, in* THREE LIVES 1, 46 (1993). "[B]ut his share had still been enough, given his easy habit of never distinguishing between principal and income, to maintain hospitable mansions in town and country and equip his family with mounts for the fox hunting that he loved more than life itself." Louis Auchincloss, *The Realist, in* THREE LIVES 89, 93 (1993). Auchincloss also pursues the theme in Louis Auchincloss, *Finish Good Lady*, *in* THE INJUSTICE COLLECTORS 64 (Signet ed. 1949, 1950) (formerly published as THE UNHOLY THREE AND OTHER STORIES). James Hilton's Mr. Chips knew to spend only income: "After 1929, Chips did not leave Brookfield . . . . His income was more than he needed to spend, and his small capital, invested in gilt-edged stocks, did not suffer when the slump set in." JAMES HILTON, GOOD-BYE, MR. CHIPS 109-10 (Little, Brown, & Co.) (1934).

[15] "Yet many investors are happy to spend their dividends, but are deeply reluctant to dip into capital." Jonathan Clements, *Behavioral Specialists Put Investors on Couch*, WALL ST. J., Nov. 28, 1995, at C1.

[16] "Bond[s] . . . used to have paper interest coupons attached. The well-heeled would clip the coupons [periodically and] . . . redeem their interest payments." John Waggoner, *To Understand Bonds, Think Like Lender*; *You Can Expect Some Income But not Big Gains* USA TODAY, Apr. 11, 2003, at B3.

[17] *See* Garland, *supra* note 1.

[18] I have chosen to leave the topic of cannibalization outside the scope of this Article. As to the topic, see William P. Bengen, *Determining Withdrawal Rates Using Historical Data*, J. FIN.

I have wondered over the years why the unitrust has such a mesmerizing effect on settlors, advisers, and commentators and why the percentage is so often 5%. This Article is my modest attempt to answer those questions. Let us begin.

This Article has two Sections. The first discusses why people are interested in a percentage solution—why the traditional regime did not work for some folks and why the percentage solution is problematic. The second discusses why the percentage is higher than I think it should be at this time, and why the chosen percent so often is 5%.

I. WHY PERCENTAGE PAYOUTS?

As indicated, this Article is about why people choose a 5% payout for their unitrusts, from their retirement savings, or their endowments, when 5% will cause a diminution of principal, at this time. We can divide this question into two simpler questions: (1) "Why do people favor a fixed percentage payout?," which I will refer to as the "percentage question," and (2) "Why do people pick too high a percentage,[19] more specifically 5%?," which I will refer to as the "why five question."[20]

I would like to address the percentage question first. Why has a meaningful switch from the traditional income-only trust to the fixed percentage unitrust occurred?[21]

PLAN., Oct. 1994, at 171; Jonathan Clements, *Retirement Models that Let Reality Bite,* WALL ST. J., Feb. 20, 2001, at C1; William J. Bernstein, *The Retirement Calculator from Hell,* EFFICIENT FRONTIER, *at* http://www.efficientfrontier.com/ef/998/hell.htm (1998).

19 I could call that the "How come so much?" question but I will not.

20 I thank Esther Wright for the "Why five?" label.

21 *See* Patrick J. Collins & Josh Stampfli, *Promises and Pitfalls of Total Return Trusts,* 27 AM. C. TR. EST. COUNS. 205 (2001); Garland, *supra* note 4; Alvin J. Golden, *Total Return Unitrusts: Is This a Solution in Search of a Problem?,* 28 AM. C. TR. EST. COUNS. 121 (2002); Robert B. Wolf, *Estate Planning with Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trust Design,* 36 REAL PROP. PROB. & TR. J. 169 (2001); Robert B. Wolf & Stephen R. Leimberg, *Total Return Trusts Approved by New Regs., but State Law is Crucial,* 31 EST. PLAN. 179 (2004). I have written the following articles with greater and lesser relevance to this topic: Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income*, 31 REAL PROP. PROB. & TR. J. 1 (1996) [hereinafter Dobris, *New Forms of Private Trusts*]; Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules,* 28 REAL PROP. PROB. & TR. J. 49 (1993) [hereinafter Dobris, *Real Return*]; Joel C. Dobris, *Why Trustee Investors Often Prefer Dividends to Capital Gain and Debt Investments to Equity—Daunting Principal and Income Problem*, 32 REAL PROP. PROB. & TR. J. 255 (1997) [hereinafter Dobris, *Why Trustee Investors Often Prefer Dividends*].

A. A Bit of History

The terms of the traditional trust, simplified, were "income to *A* for life, remainder to *B*." When a receipt came in the mail, the trustee's job was to know if the receipt was income or principal. If the receipt was income, the trustee was to pay it to *A*, and if the receipt was principal, the trustee was to allocate the receipt to *B*'s account on the trust's books and eventually pay it to *B*.[22] A trustee would learn what was principal and income from the local principal and income act and local case law.[23] While the system sounds simple, fights often arose about trustee allocations.[24] Furthermore, a trustee, in choosing the investments, had to be impartial between income and principal. A splendid investment portfolio that generated a large annual return in the form of traditional income often was unfair to the typical principal beneficiary, and a splendid investment portfolio that generated a large return in the form of capital gain often was unfair to the typical income beneficiary. The historical solution was to tell the trustee to pick a portfolio that generated a return that was fair to both income and principal. The rule often meant that the trustee had to choose an inferior portfolio of investments. The trustee paid a high price for allocation of return services. Advances in investment theory, a sharp rise in stock prices, and fashions in whether or not to pay dividends[25] led to a situation in which (1) trustees were expected to invest portfolios for total return without regard to the distinction between income and principal, and (2) trustees found that much of the return from a well-invested portfolio came in the mail in the form of capital gain allocable to principal.[26] With

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[22] *See* E. James Gamble, *If It's the 1990s, It Must Be Time for Another Principal and Income Act*, 32 INST. ON EST. PLAN. § 800 (1998); *see also* UNIF. PRINCIPAL AND INCOME ACT § 3 (1931 ACT), 7B U.L.A. 251 (2000); UNIF. PRINCIPAL AND INCOME ACT § 13 (1962 ACT), 7B U.L.A. 232 (2000); UNIF. PRINCIPAL AND INCOME ACT (1997 ACT), 7B U.L.A. 162 (2000).

[23] *See* Gamble, *supra* note 22; *see also* UNIF. PRINCIPAL AND INCOME ACT § 1 (1931 ACT), 7B U.L.A. 246 (2000); UNIF. PRINCIPAL AND INCOME ACT § 3 (1962 ACT), 7B U.L.A. 206 (2000); UNIF. PRINCIPAL AND INCOME ACT § 102 (1997 Act), 7B U.L.A. 138 (2000).

[24] *See, e.g.*, *In re* Trust of Catherwood, 173 A.2d 86 (Pa. 1961) (resolving a dispute between a life tenant and remaindermen because of trustee's allocations).

[25] A dividends-only spending rule was informally benchmarked in the psyche to a percentage standard, and as dividends as a percentage of portfolio value went down, folks began to feel sorry for themselves. They should not have. *See* Garland, *supra* note 1.

[26] *See* JOEL C. DOBRIS, ET AL., ESTATES AND TRUSTS 1092-93 (2d ed. 2003); Dobris, *Real Return*, *supra* note 21, at 53; Dobris, *The Death of the Rule Against Perpetuities*, *supra* note 3, at 627-31. *See generally* Dobris, *New Forms of Private Trusts*, *supra* note 21

out more, this would be unfair to the income beneficiary. Thus, trustees found they were not always able to make the best investments and fairly allocate receipts under traditional principal and income rules.

Two statutory solutions currently apply when traditional allocation rules fail. One solution is to give the trustee the power to reallocate or adjust receipts.[27] The other is the unitrust.[28]

Of course, if the trustee has absolute discretion over income and principal, the problems discussed in this Article disappear. The same is true if the trustee has a meaningful power to invade principal for the income beneficiary's benefit or according to some ascertainable standard. Many sophisticated drafters use these tools and, in a sense, do not need to read further. But it appears that income-only trusts still are being created.

Most private trusts created through the end of the twentieth century were traditional trusts, to the extent they had a traditional income term, but some believe that more and more private unitrusts are now being created.[29] Essentially, all of these unitrusts direct a percentage payout. Similarly, virtually all the writing about spending retirement nest eggs is couched in terms of spending a percentage of assets on hand. Why?

These days, most people think about percentages in terms of total return,[30] but it was not always that way. We used to think in terms of interest or income. Traditional spending practices for endowment funds limited spending to income, defined as dividends and interest. Traditional trusts paid the income to *A* and the remainder to *B*. Everything changed in the 1960s with the Ford Foundation[31] and the Ivy League leading the way. Professor Williamson, one of the leaders in the process of change wrote that"[t]he Yale University Treasurer's Report for 1965-66 posed the first explicit challenge to the then universally accepted premise that the appro-

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(covering modern trust options dealing with principal and income distinctions for total return on investments); Dobris, *Why Trustee Investors Often Prefer Dividends*, *supra* note 21 (illustrating principal, income, and debt preferences in trust investment).

27 *See* UNIF. PRINCIPAL AND INCOME ACT § 104 (1997 Act), 7B U.L.A. 141 (2000).

28 Settlors create most unitrusts. Some statutes allow trustees of traditional trusts to operate the traditional trust as if it were a unitrust. *Cf.*, *e.g.*, OHIO REV. CODE ANN. § 1340.42 (West Supp. 2004) (indirectly creating a unitrust that must be renewed annually). *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.4 (McKinney Supp. 2005); 12 DEL. CODE ANN. tit. 12, § 3527(b)(1) (for conversion of a trust to a unitrust).

29 *See supra* note 7.

30 *See* Garland, *supra* note 1.

31 WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND LORE OF ENDOWMENT FUNDS 1 (1969).

priate amount to spend from an endowment fund is the income yield from dividends and interest."[32] The booming stock market of the 1950s and 1960s delivered high returns, but much of it came from appreciation or capital gains, not dividends.[33] Thus, an endowment fund invested solely in bonds delivered plenty of income while losing real value, and a fund invested solely in stocks grew in real value but delivered too little traditional income. Endowment fund managers invested in bonds to get current income and gave up investments with favorable growth prospects because of their low current yield.[34] But the rising inflation of the late 1960s undermined any value this investment approach had. Not only did the value of the income stream diminish, but the capital value of the bonds at redemption did as well.[35] This new understanding of total return (that return can come in the form of capital appreciation, dividends, and interest) led to the enactment of the Uniform Management of Institutional Funds Act of 1972 ("UMIFA").[36]

To recap, conservative endowment managers of the 1960s focused on "safety and income rather than on seeking maximum long-term total return."[37] This seemed unwise and led to a change in investment allocations and to the law of endowment spending. Events in the market caused folks to think about slicing a little bit off the salami.

B. Fixed Percentages are Cheaper and Simpler

Unitrusts are easier to administer. A fixed percentage provides an easy

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[32] J. PETER WILLIAMSON, FUNDS FOR THE FUTURE 102 (1993).

[33] *See id.* at 103; RICHARD M. ENNIS & J. PETER WILLIAMSON, SPENDING POLICY FOR EDUCATIONAL ENDOWMENTS 7-8 (1976).

[34] *See* CARY & BRIGHT, *supra* note 31.

[35] *See* WILLIAMSON, *supra* note 32, at 103-04; ENNIS & WILLIAMSON, *supra* note 33, at 7-8.

[36] *See* UNIF. MGMT. OF INST. FUNDS ACT, 7A pt. 2 U.L.A. 475 (1999). UMIFA is being revised and Professor Susan Gary is the reporter. *See* UNIF. MGMT. OF INST. FUNDS ACT preface & introductory cmts. (Tentative Draft Jan. 2005), *at* http://www.law.upenn.edu/bll/ulc/umoifa/2005JanDraft.htm (last visited Feb. 9, 2005) ("With respect to endowment funds, the statute authorized a governing board to expend unrealized appreciation, even if the endowment fund provided only for the distribution of 'income.' This provision enabled fund managers to use modern investment techniques such as total-return investing and unitrust-style spending."); ENNIS & WILLIAMSON, *supra* note 33, at 7-8.

[37] ADVISORY COMM. ON ENDOWMENT MGMT., MANAGING EDUCATIONAL ENDOWMENTS 9 (2d ed. 1972).

heuristic.[38] Using a fixed percentage means that trustees, or the low-level employees of corporate trustees, or the computers used by trustees, do not need to perform complicated analyses or be programmed to perform complicated analyses. This spares the trustee from the burdens of principal and income allocation.[39] That which is cheaper and simpler allows banks greater profits. A fixed percentage also enlarges the pool of potential individual trustees who can perform the trustee function without delegation,[40] just as it allows able trustees to spend less time on trust matters, thus inducing more potential trustees to accept nominations in marginal situations or to take on more trusts. Unitrusts also make the lawyer's job of explaining trustee duties somewhat easier. Simply put, figuring out a percentage payout is easier than making principal and income allocations.[41]

C. The Unitrust Reduces the Likelihood of Lawsuits

A number of lawsuits in trust administration involve claims of misallocations of receipts or expenditures between income and principal. These lawsuits disappear in a unitrust context.

A fixed percentage payout eliminates claims of bias in investing. Under the traditional income trust, in which allocation between income and principal is made according to the nature of the receipts, a trustee had room to tilt the portfolio toward income or principal. Bonds favored

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[38] "Simply put, a heuristic is a rule of thumb. . . . 'A heuristic is a strategy, usually a simplifying strategy, which provides aid and guidance in solving a problem.'" Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 ALB. L. REV. 543, 548 n.27 (1998) (*quoting* Michael J. Saks & Robert F. Kidd, *Human Information Processing and Adjudication: Trial By Heuristics*, 15 LAW & SOC'Y REV. 123, 131 n.11 (1980-81`). What a heuristic is to a behavioral theorist is bounded rationality to a traditional economist. Every academic department has its own way of saying things.

[39] Simply put, the trustee should allocate every receipt and every expenditure to either income or principal using a complex set of allocation rules. *See* UNIF. PRINCIPAL AND INCOME ACT (1997 Act), 7B U.L.A. 131 (2000); DOBRIS ET AL., *supra* note 26, at 1092-93.

[40] *See* John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV. 105, 108 (1994).

[41] Many decision makers prefer to live in a world with fewer choices. *See* Barry Schwartz, The Tyranny of Choice, SCI. AM., Apr. 2004, at 71. Rational ignorance is rationally making decisions on the basis of inadequate information to get on with life. It may be that the human mind requires a default answer to daunting subjective questions. When a problem has answers all over the map, the mind yearns for, and supplies, a default answer that likely is a compromise and that is quantified, if quantification is appropriate.

income[42] and stocks favored principal. A trustee always had to be sure to balance the portfolio impartially between the two interests. A unitrust tends to eliminate this problem because income and principal beneficiaries are on the same page; they both want the trust to prosper as much as possible, and, disregarding taxes, they do not care whether return is income or principal.[43]

Moreover, the settlor of the trust picks the percentage payout. If a beneficiary says, "Why is this happening to me? Mommy why is she getting so much dessert?" The answer is simple, "The settlor did it to you." To put it colloquially, "What don't you understand about *x* percent?"[44] Thus, even I, the world's biggest fan of section 104 of the Uniform Principal and Income Act,[45] which gives a trustee the power to allocate return equitably

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[42] Over time, bonds harm both income and principal in an inflationary environment. *See* CHARLES D. ELLIS, INVESTMENT POLICY HOW TO WIN THE LOSER'S GAME, 40-42 (2d ed. 1993).

[43] Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 654 (2004) (observing that because the unitrust gives less discretion it reduces agency costs). Sitkoff does believe, however, that a disproportionate share of the potential upside from higher risk investments accrue to the remainder beneficiaries. *Id.* at 654. The Uniform Principal and Income Act solves this problem in a different fashion. It gives the trustee the power to adjust between income and principal if traditional rules of allocation lead to an inequitable result. *See* UNIF. PRINCIPAL AND INCOME ACT § 104 (1997 ACT), 7B U.L.A. 141 (2000). Banks are afraid that giving trustees the power to adjust could lead to more lawsuits.

[44] The unitrust is a "crystal" rule of private law. *See generally* Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988) (discussing "crystal" rules of law).

[45] *See* UNIF. PRINCIPAL AND INCOME ACT § 104 (1997 ACT), 7B U.L.A. 141 (2000). The act is discussed in Gamble, *supra* note 22. Consideration of some of the issues in the act can be found in the following articles: Dobris, *Real Return*, *supra* note 21; Joel C. Dobris, *The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future?*, 28 REAL PROP. PROB. & TR. J. 393 (1993); Dobris, *New Forms of Private Trusts*, *supra* note 21; Dobris, *Why Trustee Investors Often Prefer Dividends*, *supra* note 21. Consideration of equitable adjustments can be found in Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 IOWA L. REV. 273 (1981).

Unitrusts are discussed in Louis A. Del Cotto & Kenneth F. Joyce, *Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code*, 23 TAX L. REV. 257 (1967-1968); Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust*, 33 REAL PROP. PROB. & TR. J. 1 (1998); Robert B. Wolf, *Total Return Trusts—Can Your Client Afford Anything Less?*, 33 REAL PROP. PROB. & TR. J. 131 (1998). For a sophisticated, negative view of unitrusts, see Garland, *supra* note 4. His other papers are referenced at http://www.jeffreyco.com.html (last visited Feb. 23, 2005).

between income and principal when appropriate, admit there is room for disagreement about the sufficiency of an adjustment under section 104, and thus potential for litigation.

D. Banks Support Unitrusts

Because of the reductions in cost and complexity and the reduction in the likelihood of lawsuits, banks support the unitrust. This means a number of states statutorily bless unitrusts[46] and that banks encourage customers and their advisers to create unitrusts. Bankers get what they want from state legislatures. Where does the five hundred pound banker sit? Anywhere he wants to.

E. Fixed Percentages Look Good

Fixed percentages have a ring, a certain and authenticating quality to them. They seem to be derived from some trustworthy source, and they smack of modernity. They have the authority of mathematics and numbers; recall the Kelvin quote at the beginning of this Article.[47] As is often

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[46] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 11-2.4 (McKinney Supp. 2005).

[47] Dan Sperber, *The Art of Telling Time*, 8 CARTIER 88 (2004):

> There's an old joke about a man who goes to the Museum of Paleontology and asks the director: "How old is that dinosaur there?" The director replies: "3,000,022 years old." The man looks at the director somewhat perplexed and asks. "3,000,022 years old? How did you come to such a precise figure?" And the director responds matter-of-factly: "Very simple. When I first arrived at the museum 22 years ago, I was told that the dinosaur was 3,000,000 years old."
>
> The joke plays on a discrepancy between the need for accuracy and a preference for approximation when talking about time.

(copy on file with author) Cartier is a jewelry catalog from the famous jewel merchant of the same name. Dan Sperber is a well-known anthropologist. *See* Holly D. Doremus, *Constitutive Law and Environmental Policy*, 22 STAN. ENV. L.J. 295, 330 (2003) ("The nearly uniform call for objective decisions is understandable. Appeals to quantitative, or what Theodore Porter calls 'mechanically objective,' criteria promise transparency, predictability, and consistency.") (citing THEODORE PORTER, TRUST IN NUMBERS 11 (1995); Gina Kolata, *It Was Medical Gospel, but It Wasn't True*, N.Y. TIMES, May 30, 2004, § 4, at 7:

> But some say it has resulted in way too much testing and way too many biopsies. Dr. H. Gilbert Welch, a professor of medicine at Dartmouth College and at the Department of Veterans Affairs Medical Center in White River Junction, Vt., attributes the appeal of the number four to "digit preference." Doctors, he said, like whole numbers, they like clear results.

See also Adam Gopnik, *Through a Glass Darkly*, THE NEW YORKER, Sept. 6, 2004, at 156, 160 ("The debate is not about whether the numbers are right but whether it is right to have numbers.").

said, "This looks rather like another case in which clients would rather be precisely wrong than approximately right. The attractions of spurious precision are enormous."[48]

F. Percentage Payments and Unitrusts Are Almost Like Old Friends

UMIFA,[49] private foundation rules, and charitable remainder unitrusts led the way.[50] Advisers, prosperous donors to charities, and settlors of split interest trusts all have become accustomed to the unitrust because of the ubiquity of both the percentage payout from endowments[51] and the charitable remainder unitrust.[52] The percentage payment, and even more so, the unitrust, have metamorphosed from an exotic life form into something of

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[48] Barry Riley, *Cry from the Heart of a Passive Manager,* FIN. TIMES, Aug. 8, 2001, at 21.

[49] UNIF. MGMT. OF INST. FUNDS ACT, 7A pt. 2 U.L.A. 475 (1999).

[50] I.R.C. § 664 (2000).

[51] *See* Dobris, *Real Return, supra* note 21.

[52] A charitable remainder unitrust is an Internal Revenue Code ("Code") sanctioned, split interest trust that obtains various charitable deductions if the income goes to an individual or individuals in unitrust form and the remainder goes to charity. *See* I.R.C. § 664(D)(2) (2000):

> [A] charitable remainder unitrust is a trust—
>
> (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,
>
> (B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c),
>
> (C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g)), and
>
> (D) with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

a commonplace.[53]

We all have unitrusts now. I hope I have explained why percentages and unitrusts are enjoying a vogue.

G. Why Static, or Fixed, Percentages Do Not Work

The standard percentage solution does not work because the proper payout on assets is situational, and no percentage is ever going to be right for the long term. Payout must relate to the actual return on assets at a particular time and in a particular economy. The correct percentage varies over time. In the real world, a correct static, or fixed percentage will not occur as long as markets fluctuate. If a static percentage is chosen and if the goal is to maintain the portfolio indefinitely or turn it over to the next generation unimpaired, the static percentage must be low because of the risk that the economy, and thus the assets, will not support the static percentage over very long periods of time.

II. WHY FIVE PERCENT

A. Why Not Three Percent?

I believe that if a unitrust is to be impartial between the income beneficiary and the remainder beneficiary, it should be a 3% unitrust.[54] The retirees or other rentiers who want to turn over to their inheritors what they began with, in real terms, should pay themselves only 3%.[55] The

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53 The Internal Revenue Service website lists the number of federal estate tax returns filed or to be filed each year from 1980-2005, but unitrusts are not distinguished from traditional trusts or estates. *See* Selected Returns and Forms Filed or to Be Filed by Type During Specificed Calendar Years, Table 22.– Selected Returns. . . .Calendar Years, 1980-2005, *at* http://www.irs.gov/pub/irs-soi/04al22sr.xls. *See* Sitkoff, *supra* note 43.

54 I know that any fixed percentage is good only for a relatively short period of time and, in a perfect world, would be reconsidered periodically. *See generally* Garland, *supra* note 1 (discussing the inherent instability of spending based on market values). Such reconsideration is possible in the world of college payouts from endowments. *See* Dobris, *Real Return*, *supra* note 21. Garland expresses further reservations about 3%, essentially saying it may be too high in early 2005. *See* Garland, *supra* note 1.

55 In truth, all percentages are primitive, situational, and ideally subject to change. Three percent currently looks endowment-like and truly impartial as between income and principal. Four percent is a rational compromise with a tilt towards income. The reader may ask, "How is a payout to be determined?" I might answer, "Carefully." One might or should act mathematically, empirically. One is trying to look at real return on assets and the current and likely future state of the market. Universities with substantial assets and access to faculty economists often use fancy formulas that get adjusted every year. They tend to yield under 4%. Less sophisticated institutions tend to apply a percentage that is

person who does not want to invade principal indirectly should not spend more than 3%.[56]

Ultimately, the basis for my belief is outside the scope of this Article and perhaps outside my powers of argumentation. Having said that, let me state the point very simply and ask the reader to accept it and to continue reading.[57] Easily available equity investments cannot be counted on to provide enough to the investor in the form of dividends or capital gain to sustain a larger payment over time without reducing principal.[58]

As one might imagine, 3% is not a popular figure. Why do people want to spend more than 3%? How come nobody listens to me?[59]

1. The Simplest Answer is That Bigger is Better[60]

As the old saying goes, "Nothing wants two million like one[.]"[61] On a more serious note, there are more learned explanations are available.

2. Cognitive Biases Affect Decision Making

A number of cognitive biases affect decision making. According to

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often 5% against a rolling 3 year, smoothed, average of asset values in the endowment. This approach is primitive and creates problems such as paying out too much in bad years, creating false expectations in good years, and providing little in the way of stability for budgeting purposes. I try to deal with this in Dobris, *Real Return*, *supra* note 21. In a perfect world, spending of capital would be governed by a committee of wise elders.

[56] Trusts often provide income to *A* for life, remainder to *B* and also provide for the direct invasion of principal for *A*. *See* DOBRIS ET AL., *supra* note 26.

[57] *See* Garland, *supra* note 1 (for this argument).

[58] There is no such thing as a one decision payout percentage. Things change. I much prefer the Garland Rule. Spend 125% or 130% of the dividend stream on the Standard & Poor's (S&P) 500 and the real return on debt investments. *See* James P. Garland, *A Market-Yield Spending Rule for Endowments and Trusts*, FIN. ANALYSTS J., July-Aug. 1989, at 50, 55; Roger Hertog & David A. Levine, *Income Versus Wealth: Making the Trade-Off*, J. INVESTING, Spring 1996, at 5. Information about other papers by Garland and about updates of the cited paper can be found at www.jeffreyco.com. If 5% is the compromise for the folks who yearn for compromise, 4% is the compromise for the folks who think it ought to be 3%. David Levine, in his famous communication to his friends that was mentioned in the New York Times, speaks of 4% as a compromise. *See* Tom Redburn, *Stocks Are Best Option for Beating Inflation*, N.Y. TIMES, Feb. 16, 2003, at C4 (copy on file with author). Also note that 5% is the compromise figure between 3% and 7%, the smallest and the largest numbers one sees in this Article.

[59] The text discusses higher-than arguments. I note I am a fan of the Canadian rock group The *Weakerthans*. See www.theweakerthans.org (last visited Feb. 23, 2005).

[60] *See* SUPERSIZE ME (Morgan Spurlick and The Con 2004).

[61] AUCHINCLOSS, *supra* note 14, at 98. I prefer my own version of the thought to the quote in the text: "What is better than one million dollars? Two million dollars."

one author. "Cognitive biases are mental errors caused by our simplified information processing strategies."[62] Different cognitive biases may lead people to choose a percentage that is too high and still believe they will achieve their goal of no indirect invasion of principal.

Several cognitive biases are of interest to this Article. The first is the optimistic bias. The optimistic bias "consists of overestimating one's capabilities"[63] in investing or selecting an investment adviser. The optimistic bias may lead people to believe they, their specially chosen trustee, or investment adviser can get a superior return. They can then believe that even though a percentage higher than 3% may be overly optimistic for the ordinary investor, they can achieve a superior return.

A standard dictionary definition of optimism is interesting to consider. The Merriam-Webster's Collegiate Dictionary defines "optimism" as "an inclination to put the most favorable construction upon actions and events or to anticipate the best possible outcome."[64]

Believing everything is going to work out allows one to save less because whatever is saved, in belief, will get the desired result. Some people stop at this point in their thought process. Others give their conclusion meaning by assuming a return high enough to give them the cash stream they seek. Others simply accept the assurances of advisers who say "we believe we can obtain for our conservative clients a 7% income stream" without questioning them. I am led to say garden variety optimism may lead people to believe that everything will work out in the end, while doing little or nothing to make it happen.[65] Note that optimism can be a

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[62] RICHARDS J. HEUER, JR., PSYCHOLOGY OF INTELLIGENCE ANALYSIS 111 (1999).

[63] Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1172 (2003).

[64] MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 815 (10th ed. 2000).

[65] *See* Monty Python, *Look On The Bright Side of Life, in* THE LIFE OF BRIAN (Caroline 1997). There seems to be a disconnect between the legal world and the financial-planning world—law's "sensible" number is 5% and financial-planning's "sensible" number is 7% (or even more). Why?

There are several possible explanations: (1) Lawyers are more conservative. (2) Set tlors dealing with money in trust may be more conservative than retirees. (3) Income-only beneficiaries of trusts are often, but not always, of secondary interest to settlors. With the exception of surviving second spouses, the income-only trust in the well-drafted modern instrument is for a former servant without a pension or a dependent cousin or the like. (4) People in retirement often do not have enough capital truly to live on their income, and 5%, with its subterranean cannibalization of capital, allows retirees to pretend they are not cannibalizing their nest eggs, when they actually are. Why pretend? Retirees pretend to avoid worry and to avoid the idea that their children are not going to get the nice inherisurvival technique. The optimistic patients in the burn unit fare better than the ones who understand the extent of their injuries.[66] Any bias that leads to survival is going to loom large in the mind and be part of the emotional makeup of a large number of individuals. After all, we are the survivors.

Another cognitive bias of interest is denial. "Denial" is "an ego defense mechanism that operates unconsciously to resolve emotional conflict, and to allay anxiety by refusing to perceive the more unpleasant aspects of external reality. . . . [In other words, denial is] the suppression of reality."[67] For example, we tell ourselves the soothing lie that a higher percentage is a sustainable, non-invasive payout rate. Of course, if the lie is told regarding a testamentary unitrust, the settlor will not be around to see the money run out.[68] Also, the rentier in charge of personal assets bargains with fate that the money will not run out.[69] Any adviser who

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tance everyone thought they would get. Similarly, 5% for a surviving (second) spouse is a convenient way to lie to oneself. Often the spouse who has married a second time is torn between a desire to provide for the second spouse and the children of the first marriage. A unitrust is a convenient tool for providing for both. The 5% unitrust is especially attractive because it allows the settlor to pretend—to say that the widow will get a nice income stream and that children will not see principal reduced. When it happens after the spouse dies, well gosh and golly. He tried. Marketing also may be an issue. Imagine two financial planners, with offices next to each other. One offers 3% and the other 7%. Customers will flock to the 7% planner and, if they want to be conservative, pare it down on their own to 5%, or perhaps 6%. I thank Jim Garland for the marketing point and the articulation.

[66] As Douglas Adams wrote in THE RESTAURANT AT THE END OF THE UNIVERSE:

> [T]he Total Perspective Vortex . . . [is] "the most savage psychic torture a sentient being can undergo." . . . [W]hen you are put into the Vortex you are given just one momentary glimpse of the entire unimaginable infinity of creation, and somewhere in it a tiny little marker, a microscopic dot on a microscopic dot, which says "You are here."

DOUGLAS ADAMS, THE RESTAURANT AT THE END OF THE UNIVERSE 60, 72 (1980). Thus, the notion that the folks who recover from the serious burns do not realize the extent of their injuries. To know the truth, to not be foolishly optimistic, is to die. Optimistic people live better lives. "Psychologists have noted, however, a strong correlation between self-serving biases [overoptimism, overconfidence, and egocentrism] and psychological well-being. Only those who suffer from clinical depression, it seems, have realistic self-perception." Rachlinski, *supra* note 63 (citation omitted). We are an optimistic people. *See generally* DANIEL J. BOORSTIN, THE AMERICANS: THE DEMOCRATIC EXPERIENCE (1988) (describing the foundation and formation of the American democracy and culture).

[67] COLUMBIA ENCYCLOPEDIA (6th ed. 2005), *at* http://www.freeencyclopedia.com/html/dl/denial.asp (last visited Feb. 9, 2005).

[68] When the spaceship lifts, all bills are paid.

[69] We may be right. *See* STILL RIVER RETIREMENT PLANNING SOFTWARE, INC., RETIREMENT INCOME PLANNING, PART 3: RISK AND INVESTMENT STRATEGY FOR RETIREES, *at* http://www.stillriverretire.com/Downloads/Retirement_Income_Planning_3.pdf (May 2004)

approves the higher number may well be long gone when the money runs out.

3. Cognitive Dissonance

Let us now discuss the concept of cognitive dissonance. Cognitive dissonance is a state of mind that results from holding a belief but not following it. This situation leads to discomfort and causes people to act imperfectly to avoid the discomfort.[70] Most of the time our attitudes, knowledge, and beliefs are consistent with our behaviors and actions, and all is well.[71] When beliefs and behaviors are inconsistent, dissonance results.[72] Thus "[t]he existence of dissonance, being psychologically uncomfortable, will motivate the person to try to reduce the dissonance and achieve consonance."[73] Often these inconsistencies can be rationalized away.[74] People who know about the dangers of smoking but smoke anyway can rationalize their behavior in a number of ways: the pleasure of smoking outweighs the health risks, the chances of getting cancer are exaggerated, avoiding every danger out there is impossible, and if I stop smoking I will gain weight, which is just as bad for my health.[75] Sometimes inconsistencies cannot be explained away. When rationalization fails, one is left in a state of dissonance that is psychologically uncomfortable. (I am in favor of recycling but still throw recyclables away, and that makes me unhappy).[76]

For retirement, Able, the beneficiary, needs (or thinks he needs) *x* dollars to live on, per month, or Settlor thinks Able needs *x* dollars as income from a trust. Able or Settlor has a finite amount of money and cannot easily get more principal. Five percent seems to equal Able's needed income (enough to live on as Able is accustomed to or wants to be

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("[M]ost expenses decline or disappear as the retiree becomes infirm and loses energy. Travel, dining out, entertainment . . . tend to fade away. . . . Overall expenses . . . tend to stay relatively flat for most people past their early eighties."). Of course, this has nothing to do with a young unitrust payment beneficiary of a lifetime unitrust. This seems as good a place as any to tell the tale of a pal of mine who assumed he was entitled to whatever percentage he chose plus all traditional income.

70 *See* LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE 1 (1957).

71 *Id.* at 2.

72 *Id.*

73 *Id.* at 3.

74 *Id.* at 2.

75 *Id.*

76 *Id.* at 2. Cognitive dissonance is useful in financial contexts. *See* William N. Goetzmann & Nadav Peles, *Cognitive Dissonance and Mutual Fund Investors*, 20 J. FIN. RES. 145 (1997).

accustomed to). Able or Settlor is convinced that 5% will not cannibalize the principal because the reality of taking 5%, while understanding that the money will run out, is unpleasant (dissonance).

We convince ourselves of things that are not true to avoid or to get out of the state of dissonance.[77] "When dissonance is present . . . the person will actively avoid situations and information which would likely increase the dissonance."[78] Able or Settlor will avoid negative information and seek information that confirms that 5% is okay (which is readily available, as a later Section[79] will suggest).[80] Because Able or Settlor will have difficulty coming up with more principal and Able will have difficulty cutting expenses, Able or Settlor will take the easy route to reducing dissonance by becoming convinced that spending 5% is okay.

4. Hyperbolic Discounting

Hyperbolic discounting is over-discounting the future. Hyperbolic discounting causes some people to gamble with their retirement savings by taking too high a payout in the present. A sensible return is too dreary, and too present, so some of us kid ourselves, via the hyperbolic discounting mechanism, that a higher return is sustainable.[81] The prospect of near-term pleasure via consuming a higher percentage is more compelling than the fear of eating dog food at some distant future time. As Richard Thaler stated:

> In the morning, when temptation is remote, we vow to go to bed early, to stick to our diet, and not have too much to drink. That night we stay out to 3 A.M., have two helpings of chocolate decadence, and sample every variety of Aquavit at a Norwegian restaurant.[82]

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[77] FESTINGER, *supra* note 70, at 6. Interesting, but not directly relevant, research on how the human and animal minds process numbers can be found in the work of Stanislas Dehaene. *See* Stanislas Dehaene, *What Are Numbers, Really? A Cerebral Basis for Number Sense*, EDGE, *at* http://www.edge.org/3rd_culture/dehaene/dehaene_p2.html (last visited Feb. 23, 2005) (proposing that humans have difficulty discriminating two close quantities such as 4 and 5 even though there is a huge difference).

[78] FESTINGER, *supra* note 70, at 3.

[79] *See* discussion *infra* Section II.B.13.

[80] FESTINGER, *supra* note 70, at 6.

[81] Live for today for tomorrow we die, or, if you prefer, live for today and let tomorrow take care of itself.

[82] Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 IOWA. J. CORP. L. 1, 5 (2003) (quoting RICHARD H.

As Thaler also said, people "always consume more in the present than called for by their previous plans."[83] This is so-called hyperbolic discounting—for this Article, the undervaluing of leaving assets in a portfolio for the future and overvaluing current income.[84]

5. People Have a Sense of Entitlement to a Certain Level of Income

I believe that many people have a built-in sense that they are entitled to a particular total return and that when that feeling is given a number, it turns out to be more than 3%.[85] Indeed, as suggested above and discussed below, that entitlement turns out to be about 5%. People cannot believe that they have worked as hard as they have for their nest eggs, or an inheritance for their heirs, and are not entitled to some amount they calculate by reference to their inner (often 5%) compass. Alternatively, they cannot believe that their grandpa has left them so much money—that they have had such good fortune—but that they are only entitled to 3%.

The preceding point goes to both the rejection of the seemingly rational 3% rate and why everybody comes up with the answer 5%. Now is the appropriate point to begin the discussion of why people cling to the 5% spending rate.

B. Explanations About Five—Why Five?

Why the number five? Why not four or six or seven or ten? When a percentage payout, a unitrust, or a percentage rentier or endowment spending rule is a given, why is the number five so often chosen? Why do so many sources suggest 5% as a proper unitrust amount or as a proper spending rate out of a retirement nest egg?[86] Why do so many people

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THALER, THE WINNER'S CURSE 98 (1992)).

[83] *Id.*

[84] On hyperbolic discounting, *see* David Laibson, Intertemporal Decision Making, *in* ENCYCLOPEDIA OF COGNITIVE SCIENCE 915, 916-19 (2003); THALER, *supra* note 82, at 93-94; David Laibson & Christopher Harris, *Hyperbolic Discounting and Consumption*, *in* 1 ADVANCES IN ECONOMICS AND ECONOMETRICS: THEORY AND APPLICATIONS, EIGHTH WORLD CONGRESS 258 (Mathias Dewatripont et al. eds., 2003), *cited in* Cass R. Sunstein, *Lives, Life-Years–and Willingness to Pay*, 104 COLUM. L. REV. 205, 215 (2004).

[85] *See generally* Marci A. Hamilton, *The Era of Entitlement*. Findlaw, *at* http://writ.news.findlaw.com/hamilton/20030828.html (Aug. 28, 2003) (discussing that this is the age of the belief that one can get what one wants).

[86] *See, e.g.*, Jonathan Clements, *How Retirees Can Survive Bear Markets*, WALL ST. J., Sept. 1, 2002, at D9; Jonathan Clements, *Investors' Big Challenge: Timing the Harvest*, SACRAMENTO BEE, July 6, 2003, at D8; Jonathan Clements, *Retirement Isn't a Time to Retreat*, WALL ST. J., Feb. 1, 2004, at D9; Jonathan Clements, *Savings that Last as Long as*

accept the number? Why do so many people feel entitled to spend 5% of their assets annually, serenely sure they will do their portfolios no harm?[87] Let me offer some possible answers.

1. Five Has an Air of Compromise

Five percent is a Goldilocks number. The number is not too big and not too small; not too hot or not too cold. Compromise? Compromise between what and what? Truth be told, I believe that many sensible people would like to have, feel vaguely entitled to, or would like to default to a 10% return[88] (or at least something more meaningful than 5%). Ask lay people what dollar amount they think their savings ought to produce and their answer often turns out to be 10% of the nest egg. That is, ask people who have not thought about these things, "If you manage to save $500,000 for retirement, what do you think it ought to generate for you?," and the answer is often something like $50,000.[89] I believe folks who say that usually are told that such a return is not realistic, especially by trusts lawyers.[90] At that point, cutting the hoped-for return in half sounds quite

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You Do, WALL ST. J., July 31, 2001, at C1; Jonathan Clements, *What Retirees Can Learn From the Slide*, WALL ST. J., May 15, 2001, at C1. In the summer of 2004, mutual fund families began to suggest to retirees that they should not spend more than 4%. *See* Managing Your Assets For Yourself and Your Heirs, IN THE VANGUARD, Summer 2004, at 13. At the same time, finding a financial planner who will tell you to expect to be able to spend 7% is easy.

[87] This is something everybody feels entitled to have an opinion about. Like everyone feels entitled to run a restaurant. *See* HOWARD CANNON & BRIAN TARCY, THE COMPLETE IDIOT'S GUIDE TO STARTING YOUR OWN RESTAURANT (2002). As proof that everyone feels entitled to run a restaurant, I note that on June 2, 2004, this guide was the 2,327th best seller on Amazon.com. THE COMPLETE IDIOT'S GUIDE TO RETIRING EARLY was the 26,277th best seller on the same date.

[88] My intuition and my unsystematic inquiry of individuals lead me to this conclusion. *See* UNITED STATES TRUST CORP., WHAT THE WEALTHY THINK: THE U.S. TRUST ANNUAL SURVEY OF AFFLUENT AMERICANS *at* http://www.ustrust.com/public/ustrust (last visited Feb. 23, 2005). I say sensible people in the text because I want you to ignore the obvious point that "you can never be too rich or too thin." John Tierney, *On this Isle, Material Is No Instinct*, N.Y. TIMES, May 11, 2001 at B1. Of course, one might like 100% a day, but this is about sensible expectations. "Too rich, too thin" has been attributed to the Duchess of Windsor. *See id.* When I ask a middle-class person, "Suppose you saved $500,000 as a nest egg for retirement, what do you think it ought to give you a year?," the person says $25,000 or more often $50,000. If I say "no way" to $50,000, the response is often some version of "How about $25,000?"

[89] The result is the same if you ask, "If you had a relative who left you a million dollars, what do you think it ought to generate each year?"

[90] I believe that a world of financial planners will tell their customers that they can

accommodating and flexible on the part of the client, and so I am comfortable calling 5% a compromise number. I suspect that clients go through this process in their own mind, as much or more than in conferences with advisers, and this process also allows them compliantly to accept the suggestion made by the adviser.[91]

Five percent is also a compromise on the question of longevity: "If I am going to live to 105, I should only spend 3% and if I am going to die next year, I really should spend 55% and go to Paris. So, I will compromise and do 5%."[92]

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rely on their retirement assets to produce 7% a year, but there aren't many 7% unitrusts. *See, e.g.*, Barry Riley, *Face to Face: Future Looks a Bit Brighter, Though Still a Little Tricky: Collective Investment Funds Will Benefit From Savings Trends, But Industry Problems Remain: The Barry Riley Interview*, FIN. TIMES, Aug. 16, 2004, at 4, *available at* 2004 WL 90107329. *Compare* Jonathan T. Guyton, *Decision Rules and Portfolio Management for Retirees: Is the "Safe" Initial Withdrawal Rate Too Safe?*, J. FIN. PLAN., Oct. 2004, *at* http://www.fpanet.org/journal/articles/2004_Issues/jfp1004-art6.cfm (last visited Feb. 5, 2005) ("This paper finds that applying these Decision Rules produces a maximum 'safe' initial withdrawal rate as high as 5.8 percent to 6.2 percent depending on the percentage of the portfolio that is allocated to equities.").

[91] Five percent actually was a compromise figure for the private foundation payout rule. Some legislators wanted a 6% payout rule. *See* Steve Forbes, *Fact and Comment: Uncharitable Abuse*, FORBES, Sept. 15, 2003, at 25, 26. This is a classic example of framing. In a risk context, "framing" has been defined as:

> When people confront risky decisions—such as deciding whether to settle a case or to proceed to trial—they categorize their decision options as potential gains or losses from a salient reference point such as the status quo. This categorization, or "framing," of decision options influences the way people evaluate options and affects their willingness to incur risk. People tend to make risk-averse decisions when choosing between options that appear to represent gains and risk-seeking decisions when choosing between options that appear to represent losses. For example, most people prefer a certain $100 gain to a 50% chance of winning $200 but prefer a 50% chance of losing $200 to a certain $100 loss.

Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 794 (2001); *see also* Jeffrey J. Rachlinski, *Heuristics and Biases in the Courts: Ignorance or Adaptation?*, 79 OR. L. REV. 61, 98 (2000); Amos Tversky & Daniel Kahnemann, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S274 (1986). Chris Farrell, a regular commentator on Sound Money, a Natural Public Radio financial show said, in the summer of 2004, that one could hope to get 4% to 6% from one's retirement assets. What is the compromise figure? Answer: 5%. *See* Chris Farrell, *Retirement Countdown* (NPR broadcast, July 17, 2004) *available at* http://soundmoney.publicradio.org/display/web/2004/07/17/retirement_countdown/ (last visited Feb. 5, 2005) ("Most financial planners use a figure that you can withdraw somewhere between 4 and 6 percent of your portfolio a year."). With all due respect, I believe that most planners are not as conservative as the estimable Chris Farrell proposes.

[92] I have a friend who thinks medical advances may allow him to live for hundreds of

Similarly, 5% seems safe and sane. In the universe of all possible payout rates, 5% does not seem too greedy. It seems like a sensible bargain to make with fate. If I ask for too much I will be struck down. If I act like a little guy or if I act without hubris, maybe the fates will pass me by.[93] Also, I am entitled to slip in a little for myself.[94] Of course, the same could be said of any number lower than 5%, but five does seem to be the highest bearable low number.[95] So, five is a compromise number, and many of us like to compromise.

2. *We Just Plain Old Like the Number Five*[96]

Five has some magic power over us. We have an inordinate faith in the number five.[97] Why? The simplest explanation is that our fingers and

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years. He invests in London residential real estate. Relatively recently, *The Economist* noted that London residential real estate was the best performing asset category, in price terms, in a particular time period. *See The Foresight Saga*, ECONOMIST, Jan. 4, 2003.

[93] Just as the imperial storm troopers passed by Luke Skywalker and the droids in Star Wars under the influence of the magic of Obe Wan Kenobi. STAR WARS, EPISODE IV: A NEW HOPE (Twentieth Century Fox 1977).

[94]
> The Money River, where the wealth of the nation flows. We were born on the banks of it—and so were most of the mediocre people we grew up with . . . . We can slurp from that mighty river to our hearts' content. And we even take slurping lessons, so we can slurp more efficiently.

KURT VONNEGUT, JR., GOD BLESS YOU, MR. ROSEWATER OR PEARLS BEFORE SWINE 104 (1965).

[95] In teaching, I have found it close to impossible to teach successfully a rule with more than five elements. Indeed, students prefer rules with three factors. I have the intuitive sense that minority rules of law often contain more elements than majority rules.

[96] "Calouste Gulbenkian was a fabulously successful middleman who became known as 'Mr. Five Percent' after he secured himself a one-twentieth share in the Iraq Petroleum Company." THE RICH ARE DIFFERENT 154 (Jon Winokur ed. 1996).

[97] At the risk of seeming very strange, I note, without more, several web sites describing the magic effect of five on the human psyche. *See, e.g.*, http://www.greatdreams.com/five/five.htm; http://goldennumber.net/five(5).htm (last visited Feb. 5, 2005). In that regard, I quote the late Jesse Dukeminier:

> Why five? I have consulted books on numerology and find that Pythagoras regarded five as the number of Justice, Plato's Republic gave it as the number of the State, and five is connected by astrologers to Jupiter. A. FOWLER, SPENSER AND THE NUMBERS OF TIME 34-47, 206 (1964). A more modern numerologist says, 'Number 5 symbolizes the law of gathering new experiences.' MORRIS C. GOODMAN, NUMEROLOGY 24 (1949). I rather think this will prove to be true under the Uniform Statute.

Jesse Dukeminier, *The Uniform Statutory Rule Against Perpetuities: Ninety Years in Limbo*, 34 UCLA L. REV. 1023, 1033 n.23 (1987). So, I am not crazy, I am continuing the toes come in sets of five. Five is automatic for us. Five is our digital default number.

We think in terms of ten and to a lesser extent in terms of numbers that divide into ten. We are decimalists. We use a base ten number system.[98] Five is the largest number that divides evenly into ten, and as discussed above, no adviser will sit still for the number ten.[99] Indeed, five is the largest number for which most estates lawyers will sit still when designing a unitrust.[100] So, we are drawn to ten, numbers that divide into ten, and to the largest number that divides into ten (five), if for no other reason than a bigger return makes everyone happy, except the remainder beneficiary, who usually does not get a voice in the proceedings.

3. Five Percent Is an Easy Heuristic

Professor Sperber asserted that "[s]omeone approached in the street and asked 'What time is it?' at a point when her watch reads (for instance) 3:08 is likely to answer 'It is 3:10.'"[101] Why do we take the extra step of rounding to the nearest multiple of five rather than giving the easier and more exact answer of 3:08? Sperber also claims that speakers are trying to provide information relevant to the listener and aim for accuracy only to the extent it is necessary for relevance.[102]

Providing the time in multiples of five is relevant because the activities of most people are scheduled in multiples of five. According to

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work of a great man, Jesse Dukeminier. I offer this quote, as well: "First, the belief that endowments and trusts can spend 5% of the value of their assets in perpetuity without harming future beneficiaries is ubiquitous that it seems to be hardwired in the brain." James P. Garland, *The Fecundity of Endowments and Long-Duration Trusts*, *in* ECONOMICS AND PORTFOLIO STRATEGY, Sept. 15, 2004, at 5 (copy on file with author).

[98] "There is very little doubt that the almost universal popularity of base 10 stems simply from the fact that we happen to have ten fingers." MARIO LIVIO, THE GOLDEN RATIO 19 (2002).

[99] *See supra* note 89 and accompanying text.

[100] I think that a world of financial planners that will advise a retirement take out of 7 or 7½%. *See* Kenneth Hooker, *Options, Retirement Goal May Conflict*, BOSTON GLOBE, June 20, 2004, at C4. Interestingly, Hartford Financial offers a variable annuity which guarantees a return of principal if the principal is not withdrawn at a rate greater than 7% a year. *See* James K. Glassman, *Investing, What the Boom Will Do in 2010*, WASH. POST., May 23, 2004, at F1.

[101] Jean-Baptiste Van der Henst, Laure Carles & Dan Sperber, *Truthfulness and Relevance in Telling the Time*, 17 MIND & LANGUAGE 457 (2002), *available at* http://www.dan.sperber.com/telling.htm (last visited Feb. 23, 2005). This point is also made in Sperber, *supra* note 47.

[102] Van der Henst, Carles & Sperber, *supra* note 101.

Sperber, "This is true . . . of almost all appointments, TV programs, [movies,] and university courses."[103] An exception that proves the rule is transport schedules, which are often specific to the minute.[104] Rounding has a purpose and an explanation, so does rounding to five.

> In the absence of evidence to the contrary, then, it is likely that someone who asks a stranger in the street for the time, with no indication of his particular purpose in asking the question, will not be worse off with an answer rounded to a multiple of five. According to relevance theory, moreover, it is likely that such a person will actually be better off with a rounded answer, which requires less processing effort for the same cognitive benefit.[105]

In the context of money and time, an answer rounded to five is easy to sell and easy to buy.

Some of the situations discussed in this Article allow for the "3:08-is-3:10" type of answer. The casually consulted financial planner who advises the client that the client's assets will produce 3% when, twenty years later, they produce 2.93%, has done her job. Similarly, the retiree who takes 3% the first year of retirement and decides this percentage was a bit too generous easily can adjust in year two.[106] Here, the rounded answer is quite useful.

Rounding likely is not useful if the rounding is too dramatic, for example if 3% is rounded to 5%. Similarly, the casual answer likely is not useful if a settlor is creating an irrevocable unitrust. Having said that, however, the fact that 5% is an easy heuristic is undeniable.

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[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *See* Jonathan Clements, *Another Number to Fret About: The Key to Retirement Is Your Withdrawal Rate*, WALL ST. J., Mar. 10, 2004, at D1 (using 5%).

4. *Five Percent is a Price Point*[107]

Savvy advisers suggest 5% because it sells. It is what people want to hear. It lures in more customers. It gets them out of the office faster.

Similarly, advisers do not like to give people advice that people do not like. Nobody likes the dentist.[108] We also do not like the building inspector or the short seller.[109] We are an optimistic people.

5. *We Have Positive Associations With the Number Five*

Given a choice between five and four (a better, but not the best, percent to use for payout purposes at this time, if the goal is impartiality or

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[107] Merchants set prices that will extract the largest amount of money that a number of customers will pay. *See generally* WIKIPEDA, PRICE POINT, *at* http://en.wikipedia.org/wiki/Price_points (last modified Feb. 15, 2005) (discussing the demand for products based on pricing). Thus, one might imagine one merchant saying to another: "No one will pay more than ten dollars for a rag like that. OK. We'll price it at $9.99."

I think that 5% is the highest unitrust percentage a self-respecting lawyer will "allow." I am open to the argument that thoughtful lawyers now are counseling against 5% because that percentage is too high. Thus, I am fascinated by a statement I read but cannot find that the most popular unitrust percentage in New York in 2003 was 4.75%. Five percent is too high? How about 4.75%? Sold. I also think 5% has become the agreed upon, heuristic, quick and dirty percentage for spending out of a retirement nest egg. *See* Clements, sources cited *supra* notes 86 and 106. This assertion is more supportable to the extent that retirees can always cut back if they see that too much is being spent. Lawyers and financial planners save time and energy not arguing with clients if 5% sells. Life is the art of the possible. Do not let best get in the way of good. I think that a world of financial planners will counsel 7% because people really like this "price." "Hey, I will be retired by the time my client discovers 7% is too high."

[108] "Dentists' odds of suicide 'are 6.64 times greater than the rest of the working age population,' writes researcher Steven Stack. 'Dentists suffer from relatively low status within the medical profession and have strained relationships with their clients—few people enjoy going to the dentist.'" *See* Cecil Adams, *Do Dentists Have the Highest Suicide Rate?*, Suicide Reference Library, *at* http://www.suicidereferencelibrary.com/test4~id~1367.php (last visited Feb. 10, 2005).

[109] *See* Dobris, *Speculations on the Idea of "Speculation" in Trust Investing*, *supra* note 3. Professor Dale has written about speculation thusly: Harvey P. Dale & Michael Gwinell, *Time for Change: Charity Investment and Modern Portfolio Theory*, 3 CHARITY L. & PRAC. REV. 89 (1995) ("The use of the word 'speculative' is more pejorative than analytical. It tends to confuse more than to illuminate. There is no workable test for determining whether an investment is 'speculative.' The label is inconsistent with some of the most important teachings of modern portfolio theory, e.g., that no investment can be judged in isolation, and that diversification—even into more volatile securities—tends to reduce overall portfolio risk. It should be abjured by all careful thinkers. But just as there is no such thing as a speculative investment per se, so there is no such thing as a prudent investment per se.").

preservation of capital) people will choose five, in part, because of the positive associations. No lawyer ever offers the client six, so I cannot say if five would mesmerize if six also were offered, because if a choice is given, the choice is likely between five and a smaller number.[110]

The behavioral economics notion of "affect" plays a role. When given a choice, affect may cause people to irrationally choose the option with which they have the most positive associations. Affect is the tendency to choose that with which one has positive associations when given a choice. The number five has a special effect. Constant repetition of the number in relevant literature makes it familiar.

6. The Triviality of Five

A fairly standard statistical convention in many areas of science allows an investigator to claim to have proven a hypothesis if appropriately chosen statistical tests show no more than a 5% probability that the observed phenomenon could have happened by random chance.[111] This suggests two things. First, holy mother science has made the determination that 5% is trivial.[112] Second, and more generally, it suggests that the human mind sees the 5% of results that deviate from the successful 95%

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[110] Chris Farrell thinks that financial planners see a 4 to 6% world for retirees. With all due respect, I am less sure.

[111] Ronald J. Krotoszynski, Jr., *Back to the Briarpatch: An Argument in Favor of Constitutional Meta-Analysis in State Action Determination*, 94 MICH. L. REV. 302 (1995).

> The state action doctrine would benefit from borrowing an analytical device developed by the scientific community: meta-analysis. In the sciences, a study must have a 95% confidence rate before it will be accepted as valid. A study with a confidence rate less than 95% is not accorded dispositive weight. In a rough sort of way, this corresponds to the requirement that a defendant satisfy a particular state action test completely before a court will find the presence of state action.
>
> There is, however, an emerging trend within the scientific community toward the adoption of a new procedure called "meta-analysis." Meta-analysis involves the grouping together of data from studies with confidence rates of less than 95% in order to create a single study with a confidence rate that equals or exceeds 95%. Evidently, a growing number of scientists believes that the whole is greater than the sum of the parts. Thus, using meta-analysis, it is possible to reach the requisite 95% confidence level, even if none of the individual studies used in the meta-analysis meets the 95% threshold.

Id. at 337.

[112] As to the willingness to rely on science, see Holly D. Doremus, *Listing Decisions Under the Endangered Species Act: Why Better Science Isn't Always Better Policy*, 75 WASH. U. L.Q. 1029, 1037-39 (1997).

that prove the hypothesis as trivial. So, abracadabra, 5% is trivial, and a trivial payout is surely an acceptable payout. We always have seen a five cent item as trivial, but worth having—thus the once perceived national need for a good five cent cigar.[113]

7. Historical Data Suggests to Some that Five Percent May Be Obtainable[114]

The case for 5% is simple; historical data suggests to some that 5% may be obtainable in any given year, for any given investor.[115] I disagree.[116]

Why do I disagree? The past is not prologue. The past does not predict the future in matters of this sort. The sun likely will rise tomorrow, but who knows about stock performance. The problem is exacerbated by the human tendency to extrapolate past patterns. Yet, we are taught to judge the future by the past and that history repeats itself.[117] This concept is part

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[113] "What this country needs is a good five-cent cigar." *See* JOHN BARTLETT, FAMILIAR QUOTATIONS 673 (Emily Morison Beck et al. eds., Little, Brown & Co. 15th ed. 1980) (quoting Thomas Riley Marshall); *see also* DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH—AND CHEAT EVERYBODY ELSE 310 (2003) ("The idea that a dollar out of wages that have been taxed should earn nickels of interest free of tax has an appeal.")).

[114] See ANDREW SMITHERS & STEPHEN WRIGHT, VALUING WALL STREET 216 (2000) (indicating that the average annual yield on American stocks from 1802 to 1998 was 5.2%). I thank Jim Garland for pointing out this source, and many others, to me. Ultimately, whether a 5% payout is sustainable is outside the scope of this Article. If you believe a 5% payout is sustainable at this time, then this Article is of no interest to you. I do not and thus I am discussing a curious phenomenon and fussing about the conduct of supposedly rational actors. One easy explanation to accept is that although returns were swell for a while (i.e., once, a long time ago, in a far distant land) things are degrading to the mean as they must. *See* Andrew Smithers, *The Longer You Play the More You Lose* SUNDAY TIMES, May 16, 2004, *available at* http://www.smithers.co.uk/news.shtml (last visited Feb. 23, 2005).

[115] At one point in time, let me say in the 1960s, money earned 5%. Banks paid 5% on savings accounts, and the dividend stream on the S&P was in the four-plus range. So, some of us have a cultural memory of 5% returns that actually existed and those were conservative investments.

[116] I am not the only one. *See* Robert D. Arnott & Peter L. Bernstein, *What Risk Premium is "Normal"?*, FIN. ANALYSTS J., Mar.-Apr. 2002, at 64; Robert D. Arnott & Ronald J. Ryan, *The Death of the Risk Premium*, J. PORTFOLIO MGMT., Spring 2001, at 61; Garland, *supra* note 1.

[117] C.W. Maris van Sandelingenambacht, *Nietzsche Niëzky Nijinsky*, 24 CARDOZO L. REV. 1261, 1271, n.31 (2003) ("In *The Second Dance Song*, Zarathustra's longed-for mistress Life reproaches him that he will leave her. But then he whispers in her ear his

of our hardwiring. As Arnott and Bernstein told us, "[B]ecause investors see these same long-term historical numbers year after year, these expectations are now embedded in the collective psyche of the investment community."[118] But as Arnott and Ryan cautioned us, "Extrapolating the past is one of the most common and dangerous ways to forecast the future. The past is not prologue."[119]

The preceding paragraph refers to historical numbers. What historical numbers? Investors consider two sets of numbers. The first type is yearly returns. A number of years passed when the market returned 5% or better.[120] In approximately forty of the seventy-five years covered by the Ibbotson data, spending 5% was acceptable or even too low under the Garland Rule. Five percent was too low in the late 1970s and early 1980s and has been too high ever since then. Nineteen eighty-four was the last year that 5% was a correct rule. Since then 5% has been too high, using the Garland Rule.[121] In 1991, the payout should have been below 3% and in 1997 below 2%.

The second number investors consider is average returns. Long-term historical data suggest that over a seventy-five year period, stocks averaged an 11% return (8% real return after approximately 3% inflation).[122] Moreover, over 200 years, U.S. stocks averaged a 10% return (7% real return after approximately 3% inflation).[123] This information is correct, but there are problems. First, investors received the average return in few, if any, years. Second, no one can guarantee that any future year will produce a past average return. Third, a large fraction of past return came from high dividend yields and upwards revaluations of stock prices.[124] Today, dividend yields are low and significant stock price appreciation seems unlikely.[125] For a number of reasons, 11% returns are not a realistic expectation for the future.

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doctrine of Eternal Return—history repeats itself in great cosmic cycles; everything that is taking place now will recur again some day.").

[118] Arnott & Bernstein, *supra* note 116.

[119] Arnott & Ryan, *supra* note 116.

[120] *See* SMITHERS & WRIGHT, *supra* note 114; Arnott & Bernstein, *supra* note 116.

[121] Garland, *supra* note 58.

[122] Arnott & Bernstein, *supra* note 116.

[123] Henry Blodget, *The Wall Street Self Defense Manual Part 2: How Long is "The Long Run"?*, SLATE (July 21, 2004), *at* http://slate.msn.com/id/2103959/.

[124] I thank Jim Garland for the point. *See also* Arnott & Bernstein, *supra* note 116.

[125] *Id.*

8. The Flaw of Averages[126]

The problem with the law of averages is just that—the law is about averages. One is reminded of the joke about the statistician who drowned in a river that was, on average, only three feet deep.[127] In the investment context, the so-called "flaw of averages" occurs when investors assume they will obtain the stock market's average return each and every year.[128] As Professor Milevsky asserted, "People don't realize that averages can be meaningless. . . . It's how you get there that counts."[129] Thus, the sequence of returns is essential; poor returns early in retirement can deplete assets by reducing principal early in the game. Spending principal from a depleted portfolio early on means that even when the market recovers, one's portfolio will recover more slowly. Shares that have been sold will not rise in value when the market rises, or at least not in your portfolio.[130]

9. Regression to the Mean

Sir Francis Galton first identified the concept of regression, or reversion, to the mean when he observed that sons of tall fathers tended to be shorter than their fathers while sons of short fathers tended to be taller.[131] The sons regressed to the mean. In the stock market context this means, among other things, that "[w]hat goes up must [generally] come down."[132] Peter Bernstein told us that "bad periods in the market are *predictably* followed by good periods, and vice versa."[133] The recent bull market's av-

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[126] Sam Savage, *The Flaw of Averages*, SAN JOSE MERCURY NEWS, Oct. 8, 2000, *available at* http://www.stanford.edu/~savage/flaw/Article.htm (last visited Feb. 23, 2005).

[127] *Id.*

[128] *See* Clements, *supra* note 18; Bernstein, *supra* note 18.

[129] *Id.* (quoting Moshe Milevsky, a finance professor at York University in Toronto).

[130] People saving for retirement may discover their nest eggs are not as big as average returns suggested. Therefore the retirees may get hit twice by the phenomenon discussed in the text—too small a nest egg and spending according to plan depletes that too small nest egg.

A similar problem is that percentage returns will not be smooth and steady because of the inevitable volatility of portfolio value. *See* Dobris, *Real Return*, *supra* note 21; Garland, *supra* note 4.

[131] *See* Dan Seligman, *Good Breeding*, NATIONAL REVIEW, Jan. 28, 2002, at 53 (reviewing NICHOLAS WRIGHT GILLHAM, A LIFE OF SIR FRANCIS GALTON (Oxford 2001)), *at* http://www.findarticles.com/p/articles/mi_m1282/is_1_54/ai_81775384 (last visited Feb. 23, 2005).

[132] PETER BERNSTEIN, AGAINST THE GODS 170 (1996).

[133] *Id.* at 178 (discussing a study by two Baylor University professors, William Reichenstein and Dovalee Dorsett). The colloquial phrase is "Buy on sale." Buy your

erage annual return is almost double the 200 year average.[134] Reversion to the mean suggests that future returns likely will swing the other way. "[A]fter two decades of above-trend stock performance, we're probably due for a decade or two below trend. . . ."[135] Stock and bond performance in the near future possibly will be as good or better than during the eighties and nineties, but it does not seem that likely. "[W]e are in the early years of a 10-year to 20-year 'regression' in which the returns on financial assets will disappoint."[136]

10. The Equity Premium

Investment advisers generally understand that investors want a premium for taking the risk of investing in equity. A general assumption was that the so-called equity premium was as high as 7 or 8%.[137] A consensus is emerging that the equity premium (the return advantage of stocks over government bonds) of the future is nowhere near the 7 to 8% equity premium of the past.[138] Many are predicting a 2 to 4% equity premium, "which implies a 5% to 7% [total, nominal] annual future return for an all-stock portfolio."[139] While the idea that if equity premium goes down it indicates that stocks are less risky is appealing, this does not appear to be the case.[140] Arnott and Bernstein asserted that "[t]he observed real stock

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European small cap value allocation when the asset category is out of fashion. Buy next year's Christmas cards on Boxing Day.

[134] "From 1926 through 2003, the S&P 500 stock index achieved an average total return of 10.4 percent. (Total return includes dividends and price gains.) But for the period from 1982 through 1999, the average total return of the S&P 500 was an unprecedented 18.7 percent." Terry Savage, *Expect More Modest Gains in Stocks Over Next Decade*, CHICAGO SUN-TIMES, June 17, 2004, at 63, *available at* http://www.suntimes.com/output/savage/cst-fin-terry175.html (last visited Feb. 23, 2005).

[135] Blodget, *supra* note 123.

[136] *Id.*

[137] Paula H. Hogan, *The Shrinking Equity Premium and What it Means to Investors*, AAII J., Oct. 2002, at 17, *available at* http://www.aaii.com/promo/20040621/pswkshp.shtml.

[138] *Id.* "[T]he equity [or risk] premium . . . measures the excess return of stocks over the return offered by risk-free assets—how much higher a return we may expect, on average, from stocks than from U.S. Treasuries. In other words, it measures the compensation for the risk of being an owner." *Id.*

[139] *Id.*

[140] "[T]he relationship between risk and reward does not always hold. Over the past two decades, gold and silver, and some emerging markets have not only been more volatile than equities or bonds in America or Britain, say, but they have also yielded much lower average returns." *The Foresight Saga*, *supra* note 92, at 61. One factor contributing to low dividends is stock buybacks. Many corporations are buying back their own stock, often at

returns, and the excess return for stocks relative to bonds in the past 75 years has been extraordinary, largely as a result of important nonrecurring developments [and not due solely to risk]."[141] The high equity premium of the past was due to rising valuation levels and high dividend yields, which have since diminished and cannot be expected to return.[142] Arnott & Bernstein suggested that "future real returns for both stocks and bonds is around 2-4%" and that a normal risk premium is approximately 2.4%.[143] If their predictions are anywhere near target, those who spend 5% out of their nest eggs or who are supported by 5% unitrusts will be dining on Alpo sooner than expected.

11. Earnings and Dividends Cannot Grow Faster Than the Economy Itself

Dividend or earnings growth cannot exceed actual economic growth, in the very long run, otherwise earnings and dividends would grow larger than the economy itself.[144] To make matters worse, because some of the economic growth comes from new enterprises, in which one cannot ordinarily invest, real growth in dividends and earnings on traded stocks are capped well below the real growth of the economy.[145]

12. Fees, Taxes, and Inflation

Investors often see gross returns, not net returns. Another reason investors believe that taking 5% will not diminish their principal is that when average returns are contemplated, the diminishing effects of investment fees and taxes rarely are taken into account. Even if fees and taxes are only 1 to 2%, they still will decrease the amount that can be taken safely without cannibalizing too much of the principal.[146] "Dealing costs take a big bite out of the final value of a fund because of the power of compound interest, which exaggerates the impact of small differences in annual returns over long periods."[147] Inflation is another factor that is often

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or above market value rather than paying out additional dividends, investing in company growth, or investing in new ventures.

[141] Arnott & Bernstein, *supra* note 116, at 64, 80.

[142] *Id.* at 64.

[143] *Id.* at 64, 81.

[144] Arnott & Ryan, *supra* note 116, at 61, 62.

[145] *Id.* at 61 (explaining with clarity the idea that the greatest return is to be found when an entity is privately held).

[146] *See* Garland, *supra* note 1.

[147] *The Foresight Saga*, *supra* note 92, at 60.

overlooked.[148] Since 1913, inflation has averaged 3% per year, which means that a 7% nominal return is really only 4% after inflation.[149] Add in taxes and fees, and a 7% return becomes a 2 to 3% real return. To spend 5% without diminishing capital, one would need a 10% yearly, not average, total return.

Prosperous folks may be confusing themselves with rich folks.[150] Rich folks actually may be able to get 5% at this time.[151] It may well be that rich folks have access to superior returns, and their trustees invest in a way that allows them to pay out 5% without cannibalizing the portfolio. Taking that as so, the idea that folks with less money foolishly may think they can get the same return as rich folks is easy to believe, even though they do not have access to the better investment advice, investment classes, and investment vehicles that rich folks do.[152]

13. People Rely on Easily Obtainable Information

Information suggesting that 5% is a good idea is easy to obtain. Information suggesting that 5% is a bad idea is harder to obtain and harder to understand. Why look for complicated bad news when good news is easily available?[153]

14. Everybody is Doing It[154]

Government has sanctioned both percentages and 5%. Five percent is the mandated annual payout for private foundations.[155] Many state prin-

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[148] "Inflation can be defined as the overall general upward price movement of goods and services in an economy." U.S. Dep't of Labor Bureau of Labor Statistics, Overview of BLS Statistics on Inflation and Consumer Spending, *at* http://www.bls.gov/bls/inflation.htm (last modified Dec. 28, 2004).

[149] MoneyChimp, *Inflation*, *at* http://www.moneychimp.com/articles/econ/inflation_calculator.htm (last visited Feb. 23, 2005).

[150] I speculate about this in Dobris, *Speculations on the Idea of "Speculation" in Trust Investing*, *supra* note 3, at 474-75. One also is reminded of the woman at the table next to Meg Ryan's table in the famous scene in WHEN HARRY MET SALLY (Castle Rock Entertainment 1989).

[151] *See* Dobris, *Speculations on the Idea of "Speculation" in Trust Investing*, *supra* note 3, at 474-75; Sullivan, *supra* note 2.

[152] I try to grapple with this in Dobris, *Speculations on the Idea of "Speculation" in Trust Investing, supra* note 3. Rich folks often, but not always, pay lower fees, too. I thank Jim Garland for this point.

[153] *See generally* Clements, sources cited *supra* notes 86 and 106.

[154] THE CRANBERRIES, EVERYBODY IS DOING IT, SO WHY CAN'T WE? (THE COMPLETE SESSIONS 1991-1993) (Island Records 1994).

[155] I.R.C. § 4942(e) (2000). The 5% charity rate is misleading to the extent that charities

cipal and income statutes incorporate unitrusts[156] and inferentially bless a 5% payout, in some fashion, in their unitrust section.[157] Recent regulations under section 643 of the Code allow a marital deduction for unitrusts if the unitrust amount is between 3% and 5%, and a state statute allows a unitrust for a surviving spouse.[158] Many colleges and universities use percentage payouts when they spend from endowment and, having made the percentage payout decision, many choose a 5% spending rate.[159] If this percentage is good enough for Uncle Sam, the state legislature, and the state university, then the percentage is good enough for me. In other words, the 5% unitrust and the 5% spending rate is a tree with deep roots.

III. CONCLUSION

When I began thinking about this question, the certainty that 5% trust payouts were sustainable was monolithic. As time has gone by, some people have come to understand that 5% is optimistic, at best, at this time. I would say that reason has begun to erode the emotional certainty that we are all entitled to 5%. I do, however, think decades will pass before "why five?" will be an irrelevant question.

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currently are allowed to allocate certain costs of operation and treat them as distributions; that is, the law does not require the actual expenditure of 5% for charitable purposes. *See* Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1126 (2001); Peter Frumkin, *The Ironies of Foundation Regulation*, THE CHRON. OF PHILANTHROPY, Feb. 5, 2004, at 31. ("Under the plan, foundations would no longer be able to count administrative assets, such as salaries and office rent, when figuring whether they meet federal requirements to distribute at least 5 percent of their assets to charity each year.") This column is based on Peter Frumkin, *Trouble in Foundation Land: Looking Back, Looking Ahead*, *at* http://www.hudson.org/files/publications/FrumkinMonograph.pdf; *see also* I.R.C. § 664 (dealing with charitable remainder unitrusts and engages the notion of a minimum 5% payout).

[156] Delaware has made a statutory provision for unitrusts. *See* DEL. CODE ANN. tit. 12, § 3527 (2004); *see also* http://www.leimberg.com/freeResources/truStates.asp (last visited Feb. 8, 2005).

[157] Delaware has made a statutory provision for 5% unitrusts. *See* DEL. CODE ANN. tit. 12, § 3527 (2004). A Delaware 5% unitrust is dealt with in McNeil v. McNeil, 798 A.2d 503 (Del. 2002); *see also* Sitkoff, *supra* note 43, at 652-54 (discussing the unitrust).

[158] Treas. Reg. § 1.643(b) (2004) (defining "income" for trust purposes).

[159] *See* Dobris, *Real Return*, *supra* note 21; *see generally* Garland, *supra* note 1.